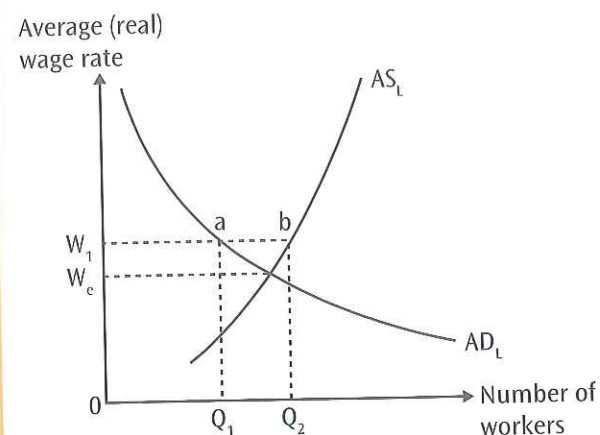


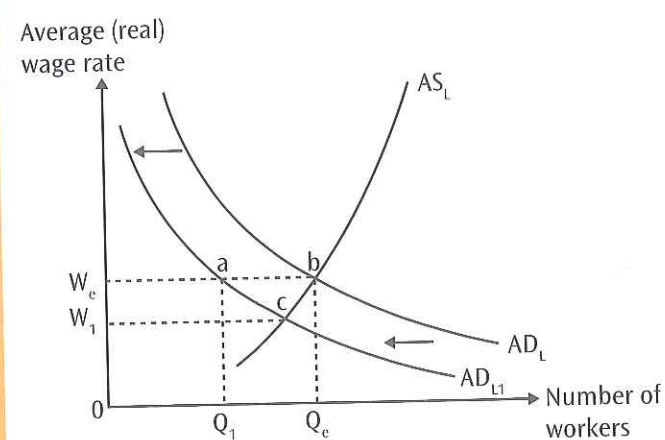
## Unemployment and inflation

### Real wage unemployment



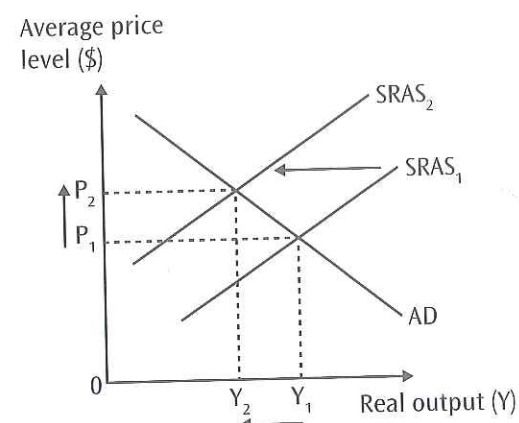
Real wage unemployment occurs when a trade union, or the government, raises the wage rate above the equilibrium, from  $W_e$  to  $W_1$ . There is unemployment of  $Q_1Q_2$  where the  $AS$  of labour exceeds the  $AD$  for labour.

### Demand deficient unemployment



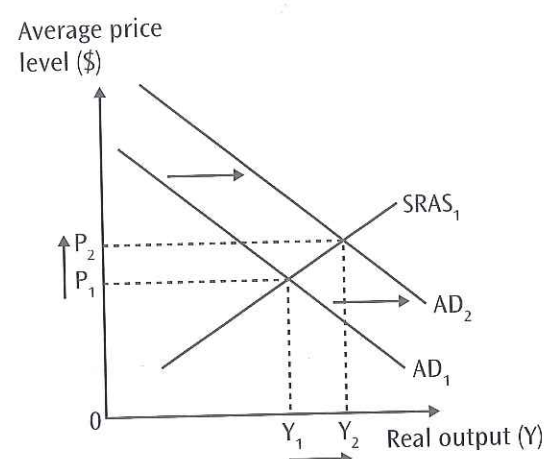
Demand deficient unemployment occurs when the demand for labour falls from  $AD_L$  to  $AD_{L1}$ , but (real) wages remain at  $W_e$  rather than falling to  $W_1$ . There is unemployment of  $Q_1Q_2$ .

### Cost-push inflation



When there is an increase in the costs of factors of production, such as wage increases or increases in oil prices, then firms' costs are pushed upwards, the  $SRAS$  curve shifts from  $SRAS_1$  to  $SRAS_2$ , and the average price level rises from  $P_1$  to  $P_2$ . This is cost-push inflation. Real output also falls from  $Y_1$  to  $Y_2$ .

### Demand-pull inflation



An increase in  $AD$ , caused by a sustained increase in any of the components of  $AD$  will shift the  $AD$  curve from  $AD_1$  to  $AD_2$ , and the average price level will rise from  $P_1$  to  $P_2$ . This is demand-pull inflation. In this case, real output increases from  $Y_1$  to  $Y_2$ .



## You should be able to evaluate:

- the consequences of supply-side policies
- the effects of an increase or decrease in interest rates
- the view that controlling inflation should be the main objective of governments
- whether inflation or deflation poses the greater economic problem
- whether demand-side policies are the most effective way to reduce unemployment
- the policies used by a government to reduce income inequality.

**Remember to make reasoned judgments or conclusions.**

The following is a typical question from paper 1 part (b) and you should spend approximately 35 minutes on it.

**Evaluate** the view that governments should make the control of inflation their highest priority.

15 marks

[Taken from SL paper 1 May 2007]

### How do I approach the question?

First, you need to identify what the question is asking you to evaluate, which in this case is the proposition that the control of inflation is more important than the achievement of other economic objectives.

So now you should begin by defining terms, in this case inflation. Then you should identify the main economic aims of governments: low inflation, low unemployment, economic growth, a current account surplus, and an equitable distribution of income.

Now you might introduce the consequence of inflation and the problems that it causes. You might then do the same with unemployment and a persistent current account surplus.

You might look at the possible relationships between the economic objectives, such as controlling inflation leading to increasing unemployment (a trade-off), as well as low inflation helping to achieve economic growth, a current account surplus, and a more equitable distribution of income.

Now evaluation can take place. You might compare the arguments for and against controlling inflation instead of other aims and then decide that the arguments for are more weighty than the arguments against, since inflation can literally destroy economies, such as in Zimbabwe, whereas the other problems, while bad, do not affect everyone to the same extent and do not cause such long-term damage to the economy.

### What are the key areas from the syllabus?

- Major macroeconomic issues facing countries
- Inflation
- Unemployment
- Economic growth
- Balance of payments
- Equity

### What needs to be defined?

- Inflation
- Unemployment
- Economic growth
- Balance of payments
- Equity

### What diagrams do I use?

- $AD$  and  $AS$  diagrams to represent inflation, unemployment and economic growth outcomes



## This answer achieved 3/15

The student failed to define inflation in part (a) and did not do so here. Statements about controlling inflation are made, but not explained, and then the student begins to discuss ways of controlling inflation. The last part seems to imply that controlling inflation would lead to an increase in real GDP, which is incorrect.

If a government was to make controlling inflation their main priority, and if they were to achieve it, they would find the currency more stable, the economy as a whole more stable and also make the balance of payments equal to one another without government intervention. However, to be able to achieve this, the government would need to cut the power of trade unions in order to prevent an increase in workers wages. The government would also have to subsidise big producers so that their supply does not decrease and cause prices to rise. If the government wished to make inflation control the highest priority then they would also need to influence consumption and demand as this will lead to an increase in real GDP.

The student makes a statement regarding the benefits of inflation, without having identified them, and then makes an unsupported assertion.

The benefits of controlling inflation are great, however I believe the methods to get there are tough to achieve and very time consuming, so all in all I do not believe this view to be followed by governments world wide.

## Examiner report

The student showed little understanding of the specific demands of the question. There was very little recognition of relevant economic theory and none of the relevant terms were defined. There was a significant error. This puts the response into level 1 and explains the 3 marks given.

The student made the common mistake of making unsupported and unexplained statements, such as "If a government was to make controlling inflation their main priority ... they would find the currency more stable, the economy as a whole more stable and also make the balance of payments equal to one another without government intervention". The student also wrote away from the point, offering methods of controlling inflation; level 2 could not be awarded.

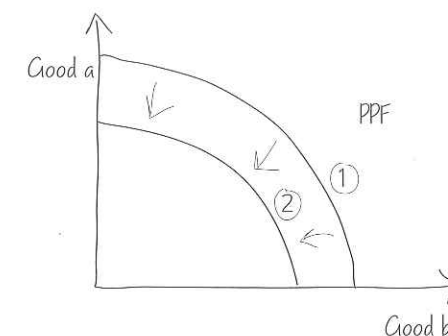
## This answer achieved 9/15

The student had already defined inflation in part (a) and so did not need to do so here. The student then provides a reasonable list of the consequences of inflation with some, if rather brief, explanation, although the comments relating to terms of trade are incorrect.

Controlling inflation is one of the economic goals in macroeconomics. There are high costs associated with inflation. Firstly, there are menu costs, the physical costs of continuously changing prices and the resulting inefficiencies. Secondly, there are shoe leather costs, as wages will have to be spent right away before money loses its value. Adding to these problems is the likely current account (record of visible and invisible trade and net income from abroad) deficit and thus an unsustainable Balance of Payments disequilibrium. For developing countries in particular this is problematic due to the deteriorating terms of trade (TOT). It will not be possible for them to grow and develop through trade because their main exports are relatively price inelastic, decreasing export revenue, as the TOT fall. Inflation adds to this problem by widening the current account deficit.

Furthermore, high inflation will lower the use of money and there may be a bartering economy, where profitable large transactions become difficult. There will be a fall in confidence in the banking system because money is continually losing its value.

The diagram is incorrect. There has been no change in the quantity and/or quality of factors of production and so the production possibility frontier (PPF) would not shift.

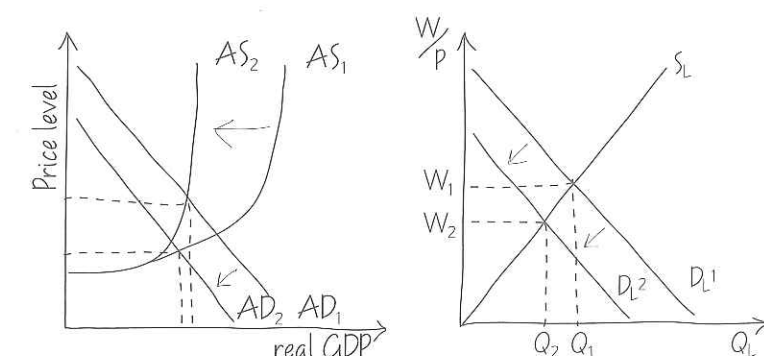


Therefore there will be inefficient barter and saving, which leads to a fall in the potential output of the economy, as the production possibility frontier (PPF) diagram shows. The potential output now only lies at curve 2, not 1.

There is an attempt at evaluation here, but a full justification is not given.

The most important problem due to inflation is, however, the uncertainty that will spread through the economy. Firms will not be able to plan ahead and calculate the costs of their production. Therefore they will not be able to invest.

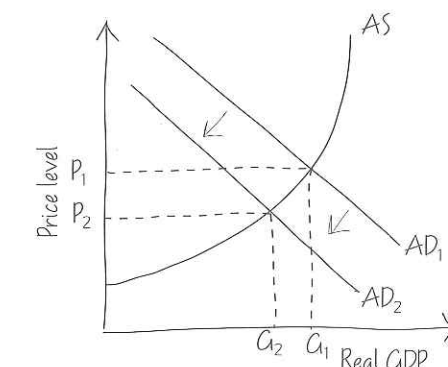
There is confusion here early in the answer. There is no justification in the claim that "AS is likely to fall". However, the later explanation relating to "winners from inflation" is valid.



AD will fall, and as firms also employ less, there is likely to be more unemployment because wages are sliding downwards. They stay at  $W_1$ , leading to unemployment from  $Q_2$  to  $Q_1$ . Also AS is likely to fall, contributing to a fall in real GDP, as the costs of production rise. Therefore inflation will cause an economic recession. These reasons suggest that governments should focus on reducing inflation. On the other hand, there are also winners from inflation. Those people that were in debt and have borrowed will profit as the value of money and thus the value of their debt falls. If domestic firms have borrowed they may also profit from inflation. This could encourage them to invest more, increasing GDP growth.

A further problem with combatting inflation is the detrimental effect deflationary monetary and fiscal policy can have. If taxation is raised, for example, AD will fall leading to less inflation.

The student does not specify direct taxation.







The student makes some reasonable comments regarding problems that may arise if inflation has to be controlled by monetary and fiscal policy, although there is confusion relating to value added tax, which would not be a demand-side policy and would not shift the AD curve.



Not an evaluative conclusion. One is left asking the question "Why?". No reasons are given for the assertions.

But this also means that people have less income, and that real GDP will fall. If the rise in taxation is a rise via the value added tax only the poor will truly be hit because the money they lose is a greater proportion of their income. This seems rather unfair. Similarly, only the rich will truly profit from a rise in interest rates, because they have greater wealth to save, whereas the poor and worse educated are more likely to become unemployed in a recession and will not make a lot of profit due to interest rates. There are, therefore, a number of difficulties and detrimental effects of the tools the government can use to control inflation.

In conclusion, I would nevertheless say that inflation is the main problem in an economy. Governments should control it, even if it is painful to do so at times, because if they do not then the effects of inflation will be worse than those of an intervention.



## Examiner report

The student showed some understanding of the specific demands of the question and recognized some of the relevant theory. Some relevant terms were defined, but not all. There were errors in the explanation. This puts the response clearly into level 2, at the top of it, and explains the 9 marks given.

The student made reasonable attempts at an explanation related to the question, but had a tendency to make mistakes whenever attempting to go into more depth and so level 3 was not awarded. There seemed to be a basic understanding of the concepts involved, but an inability to apply the theory to answer the question. The diagrams, one of the most important analytical tools of an economist, were weak and needed to be improved to reach higher levels of achievement.



## This answer achieved 14/15



The student refers to different types of inflation in part (a) of the answer. The student ties inflation in with exchange rates and interest rates, and defines terms.



The dangers of cost-push inflation are introduced and there is a hint of evaluation with the term "especially". However, the statement that cost inflation "means a recession in the economy" is misleading and not necessarily true.

Inflation in an economy can be caused by lower exchange rates and lower interest rates. This in turn causes imports to become more expensive and exports to become less expensive. While having less expensive exports might make the domestic producers of exports more competitive, expensive imports can lead to pressure on domestic producers, which can then cause unemployment as they try to save on factors of production. Unemployment is when the number of people willing and able to work exceeds the number of jobs available. Factors of production include land, labor, capital, and management.

Problems with inflation arise especially with cost-push inflation, because this kind of inflation means a recession in the economy, which will cause the economy to become less competitive and ultimately unstable. This can then lead to unrest in the country and dissatisfaction with the government which would be voted out of office.



The student now uses a good diagram to explain and develop the answer. Evaluation is introduced with "the greatest problems" and a justification of the importance. There is also a relevant real-world example used.



A very good section; the student defines terms, introducing different types of unemployment, and evaluating the relative problems of inflation and unemployment.

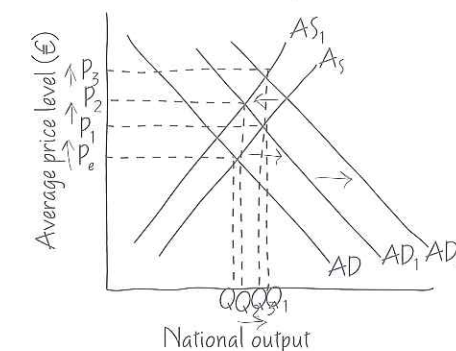


The student stresses the importance of inflation and control policies are introduced.



The diagram is well drawn and labelled and there is an evaluation of the possible policies for controlling inflation.

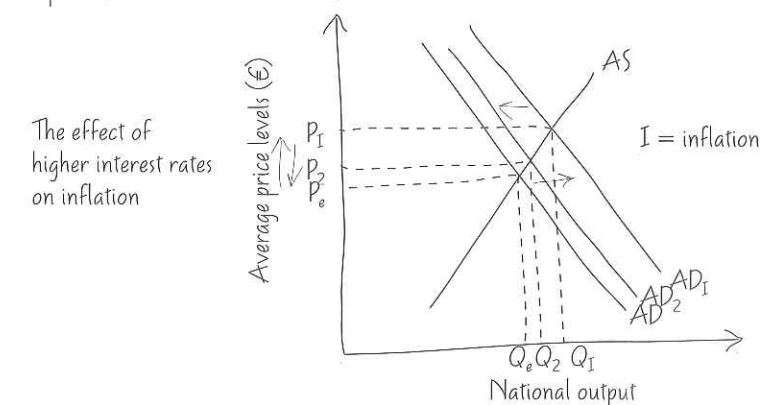
The greatest problems, however, arise from an inflation spiral, drawn below.



As can be seen above, employment is not rising proportional to inflation, causing not only employment problems but also instability. The prices soar and can change very quickly, thus leading to a situation similar to the one in Zimbabwe where shops have a different price for goods almost every day and where money has lost nearly all value. This is not only bad for the economy, but also for the government since many people will be dissatisfied with the government, causing civil unrest and perhaps even civil war.

The other main thing which the government will have to worry about, unemployment, is less serious than inflation. This is because there will always be some people who are unemployed, and frictional and seasonal unemployment exist in all economies at any one time. Frictional unemployment is where people leave a job and then spend some time unemployed while looking for another job (due to among other things, maternity leave). Seasonal unemployment is when employment depends on the seasons of the year (e.g. ski instructors in the summer). Thus, there is less the government can do about unemployment and it is not as high a priority as inflation (unless unemployment is exceedingly high).

Inflation, on the other hand, has a far more direct influence on trade due to its effects on interest rates, exchange rates, and aggregate demand. The government can choose to cure inflation by either demand or supply side policies. Demand-side policies are generally more effective because they take less time to execute and have an effect on the economy. There are two demand-side policies, monetary and fiscal policies. Monetary policies involve interest rates and fiscal policies involve taxes. If the interest rate is made higher, then there will be a higher exchange rate, which leads to exports being more expensive, which then leads to less AD, shown below.



The only problem with this is that it may cause unemployment problems. Raising taxes will also have a similar effect on AD, as people will spend less and AD will therefore shift to the left. The safest of the two policies is probably the monetary policy, since raising taxes will not make the government more popular, and it is also the policy most used in reality.

In any case, governments should make the control of inflation their highest priority





## Examiner report

The student clearly understood the specific demands of the question and explained and developed relevant theory. Economic terms were defined and there were no significant errors. Well-drawn and labelled diagrams were introduced and explained. An example was used and there was evidence of evaluation, which puts the response clearly into level 4 and explains the mark of 14 awarded.

The student's answer shows elements of all of the necessary ingredients for a top response. If terms are defined, concepts introduced and explained with the use of diagrams, examples given, and supported evaluation made then success is guaranteed. In this case, being hypercritical, it could be argued that more use might have been made of examples.

The following is a typical question from paper 2 part (d) and you should spend approximately 15 minutes on it.

### Indonesian central bank raises interest rates to slow down inflation

- On Tuesday, Indonesia's central bank **tightened monetary policy** for the third time in five weeks, raising the country's base interest rate to 11.0% as it struggles to keep control of inflation. The inflation rate is predicted to rise after a huge increase in fuel prices last month. The Bank of Indonesia Governor told reporters that the aim of the interest rate increase "is to cool down the temperature of the economy". He indicated that further interest rate rises are possible.
- Since it was introduced on 5 July, the Indonesian base **interest rate has been raised four times** to follow the increase in the US Federal Reserve's rate, to stop the continued fall in the value of the Indonesian currency, the rupiah.
- The State Minister for National Development Planning warned that inflation may grow to 12% from 9.06% year-on-year in September, the highest level in 33 months. As well as the fuel price rise, the depreciation of the rupiah against the US dollar has added to inflationary pressures.
- Prices of consumer goods and basic commodities have risen uncontrollably since the increase in fuel prices. Producers and dealers of motor vehicles, electronics and food have raised prices by significant amounts.
- Food prices and transportation fares are very likely to double before the Muslim fasting month that begins Wednesday this week.
- "I think that the central bank is being responsible, especially when it looks like the inflation rate is about to rise," said a vice president of regional economics at CIMB-GK Research. He said "inflation could rise to 15% in October from a year ago. However, the interest rate increase **will slow down economic growth**. Now the best-case scenario is around 5% growth over the next 12 months."

[Source: adapted from *The People's Daily*, 4 October 2005]

Using information from the text and your knowledge of economics, **evaluate** the likely effects of higher interest rates on the Indonesian economy.

8 marks

[Taken from SL paper 2 November 2007]

### How do I approach the question?

First, you need to identify what the question is asking you to evaluate, which in this case is the effects that high interest rates will have on the Indonesian economy.

You could define interest rates and then explain that interest rate changes are a form of demand-side policy. You could then define demand-side policies, explaining that they are used to shift the AD curve.

Now you may draw an AD and AS diagram showing a shift of the AD curve to the left, a fall in the average price level and a fall in real output.

Now you can explain that the higher interest rates will lead to a fall in consumption, as consumers borrow less, save more, and thus purchase less. There will be a fall in investment, as firms borrow less, and thus invest less in new capital. There will be an increase in the exchange rate, as short-term funds enter the country attracted by the higher interest rates, as implied in paragraph 2.

You can use paragraph 1 to explain that there should be a fall in inflationary pressure; you can use paragraph 6 to discuss the implications of falling investment on economic growth.

Now evaluation can take place. You might compare the different outcomes: lower inflationary pressure, lower economic growth, and likely increases in unemployment, and then give a judgment as to whether the control of inflation is worth the loss of growth and employment. You might use the argument that inflation is worse than any other economic ill, because it can destroy economic systems and so the higher interest rates are justified. You might compare the internal effects on the economy and the possible effects externally of a higher exchange rate making a judgment as to whether the control of inflation is worth the problems that will occur with net exports.

### What are the key areas from the syllabus?

- Monetary policy
- Economic growth
- Inflation
- Unemployment
- Exchange rates

### What needs to be defined?

- Interest rates
- Demand-side policy
- Monetary policy

### What diagrams do I use?

- AD and AS diagrams



### This answer achieved 2/8



The student does not define terms and mentions cooling down of the economy, but does not explain how this happens and does not use a diagram. The student goes off the topic with the comments regarding cost-push inflation.

The higher interest rates on Indonesian economy will cool down the economy over heating or at least slow down. By the contract securing policy, the spending will be discouraged however, the oil price rise is a overseas sector which can cause cost push inflation. When cost-push inflation starts, the monetary policy can not reduce the effects.



The following is a typical question from paper 1 part (b) and you should spend approximately 35 minutes on it.

**Evaluate** the proposition that the priority in economic management should be the maintenance of low unemployment.

15 marks

[Taken from HL paper 1 May 2007]

### How do I approach the question?

Remember that the question often offers key words to guide you. In this case, the hint is "the priority". This should make you remember that governments have several objectives and your task will be to evaluate the relative importance of those different objectives to determine what the priority should be. Essentially, the question is asking you to decide whether the priority should be the maintenance of low unemployment, or whether it should not be. You should explain the different goals of governments, discuss the trade-offs that may exist, and come to your own conclusion. Remember that there is not one correct answer, but you will have to justify your conclusions with the relevant economic theory.

One obvious approach here would be to look at the consequences of the different objectives, especially unemployment and inflation, and to attempt to evaluate which is the more damaging to the economy and so which needs the higher priority in terms of control.

Don't forget to include current real world examples that you have learned. Ideally, you will be familiar with some policies and statistics of a particular country (possibly, but not necessarily your own) and you should integrate them into your answer.

### What are the key areas from the syllabus?

- Main objectives of economic management
- Growth
- Low unemployment rate
- Low inflation rate
- Positive balance of trade and equity
- Economic strategies available to governments

### What needs to be defined?

- Whatever goals of economic management and whatever economic strategies that you introduce. In this case, at the very least unemployment should be defined, since it appears in the question.

### What diagrams do I use?

- Macroeconomic diagrams, such as short-run and long-run AD and AS diagrams.



A short-run Phillips curve is drawn, but not accurately. It should cut the horizontal axis at the natural rate of unemployment.



The student introduces the vague phrase, "a healthy relationship between unemployment and inflation".



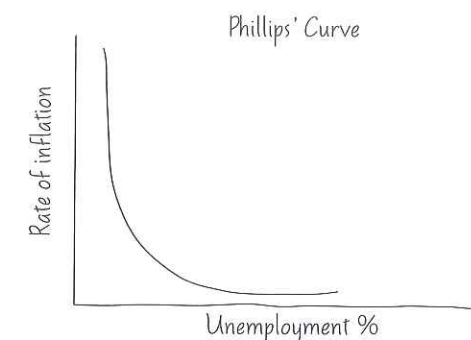
A poor diagram, with an inaccurate curve and a lack of actual figures on the axes.



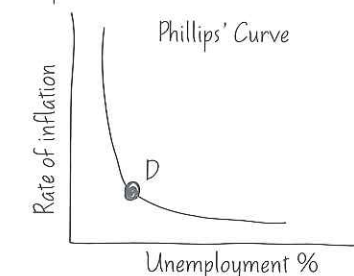
The student writes about relatively low levels of unemployment and inflation but, without actual figures, there is nothing to show that the student understands what "a low healthy level" of inflation or of unemployment means. Indeed, without definitions, there is nothing to show that the student understands what inflation and unemployment themselves are. Growth and development as priorities are introduced, but again not defined.



The student loses sight of the question and makes a number of unsupported statements.



An economy geared towards a concept as such should reevaluate its goals and strive not for low unemployment but for a healthy relationship between unemployment and inflation. A graphical example of where this relationship would be most beneficial is seen below, marked by point D.



At this point both levels of inflation and unemployment are relatively low and a balance between these two is maintained. Therefore inflation will remain at a low healthy level and so would unemployment, yielding a healthy balance and overall healthy economy. However, this prioritizing of unemployment and inflation should generally be done in MDC's (more developed countries) as opposed to LDC's (less developed countries). In LDC's the economic concern and priority should be yielded more towards economic growth and development.

Economic growth and development are more important in this case because in order to have jobs in an economy: Land, Labor, Capital, and Enterprise must be developed to a satisfactory level. Also the economy must grow to produce these jobs for the people. These would be the top priorities for an LDC as opposed to an MDC which would yield its priorities more towards a healthy balance between unemployment and inflation.



This answer achieved 4/15



The student attempts to answer the question without explaining anything first, which is always a mistake. No definitions are offered. The Phillips curve is introduced, but not explained.

The concept of yielding priority in an economy to the reduction of unemployment is not that wise. Depending on the economy or the country for that matter, is how one should prioritize things in an economy. If low unemployment was the focus of an economy, that same economy would be bombarded by high inflation as per the Phillips' Curve.



### Examiner report

The student showed little understanding of the specific demands of the question. Few relevant concepts were recognized and there was no attempt to define relevant terms. This puts the response into level 1 and explains the 4 marks given.

The response is a classic example of how a lack of early definition of key, relevant terms can damage an essay. Without definition of terms, it is almost impossible to show understanding. At no point did the student indicate what unemployment was and why it may, or may not be a priority in economic management. In simpler words, the student did not really answer the question and so level 2 could not be awarded.





## This answer achieved 6/15



This is another case of the question being answered before any definition or explanation has been given. The student introduces eight economic concepts without defining a single one.



The student implies that a low rate of inflation may be beneficial to the economy, but does not explain why.



A Lorenz curve is introduced, although the labelling needs to be clearer, as does the line of absolute equality (the 45-degree line).



The diagram is explained, but the student does not say why low unemployment will cause income to be better spread.



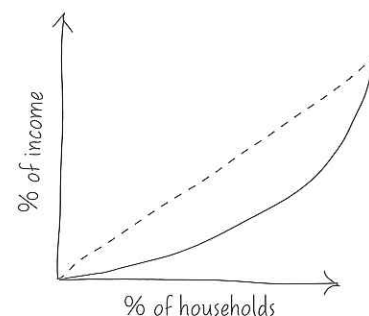
The student offers a reasonable diagram to show a trade-off, but again there is no worthwhile explanation.



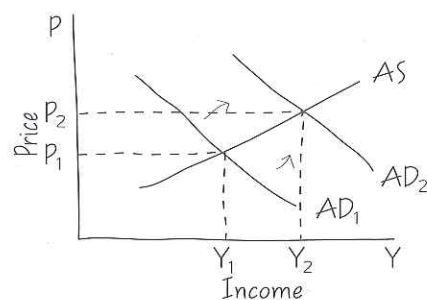
The student goes off the topic, writing about how to deter hyperinflation. Once again, no definition is given and the explanation is wrong, since the purpose is not to stimulate investment as such.

It is best to maintain low unemployment since the higher the number of working people, the better the money supply is spread out. It is better to cause a little inflation than a little deflation. The increasing number of workers receiving income will lead to increased demand. This will cause prices to jump up a little with the use of monetary and fiscal policies. The increased demand will ultimately increase profit and lead to higher economic growth.

In addition, the increase of prices will increase the amount of investment, domestic and foreign. Consumers with disposable income will start investing their money, hoping to get a larger return. This investment will help firms update their technological equipment and improve working conditions. The firms may also increase workers' wages, causing their standard of living to improve. Thus, the maintenance of low unemployment ultimately, in the long run, leads to increased economic growth and development.



This graph is an example of a Lorenz Curve. It shows how the income is distributed in an economy. The dotted line represents an economy where the income is perfectly distributed among its individuals. The low unemployment will cause the total income to be better spread out, as shown in the graph.



This graph shows how higher income leads to an increase in price level due to increased demand.

To deter a hyperinflation, the government may increase interest rates to promote investment. Consumers will invest more because they will receive a higher return due to high interest rates. This will help to stabilize the amount of money in circulation and also stabilize the demand. More people will invest or put their money in savings account, thus leading to lower demand of goods and services.



## Examiner report

The student showed some, although minimal, understanding of the specific demands of the question. Some relevant concepts were recognized and there were two vague attempts to define relevant terms. This just puts the response into level 2 and explains the 6 marks given.

There seemed to be a significant lack of planning in this answer. Without definition and structure, answers tend to do exactly what this one did, which is to jump from idea to idea without answering the set question. An explanation of the costs of unemployment and why it is important to control it would have made all the difference. Comparing the costs of unemployment with the costs or benefits of other aims would have been even better.



## This answer achieved 13/15



The student has already defined terms in part (a). The student introduces and explains the idea of a trade-off between inflation and unemployment and suggests that focusing on reducing unemployment will cause inflation.



The student defines and explains supply-side policies and suggests that it is possible to achieve low levels of unemployment without worrying about high inflation if you believe in the workings of supply-side policies. Examples are given as to how supply-side policies can cure different types of unemployment and the lack of a trade-off is explained by referring to the diagram below.



The student gives an accurate, well presented diagram with a short explanation.

The proposition that the priority in economic management should be the maintenance of low unemployment leads to the classical debate between demand and supply-side economics. As already formulated in 2.a) demand-side policies or government intervention such as monetary or fiscal policy seems only able to be able to cure either problem, inflation or unemployment. Through factors such as the wage price spiral, we see that by focusing on the problem of unemployment and correcting it through monetary or fiscal policy leads to high levels of inflation, an undesired economic problem.

Supply-side economics focuses on the other hand automatically on maintaining low employment as they generally deal with shifting the LRAS curve outwards to the right, lowering levels of unemployment automatically in effect. Supply-siders believe that through improving the quantity and quality of the factors of production, they can in the long run increase economic output and welfare. By educating the work force and improving human capital mobility they will be able to cure structural unemployment, thus increasing output and shifting the LRAS curve outwards. By removing the welfare benefits to the unemployed they will also increase the work incentive causing further lowering of unemployment rates. All in all, supply-side policies will increase efficiency and lower unemployment in the economy, as illustrated in Figure 2.3 where a shifting of the LRAS curve from  $LRAS_1$  to  $LRAS_2$  represents, at the new equilibrium  $PC_2$ , a lowering of unemployment as well as an increase of output in the economy and a dampening of inflation.

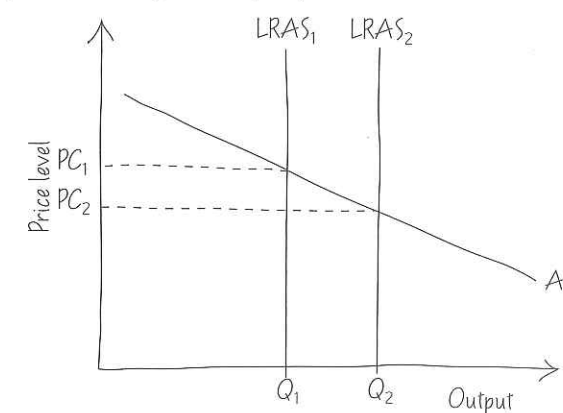


Figure 2.3

The already mentioned dampening of inflation shows therefore how supply-side policies, which automatically insist that unemployment levels will fall, lead to an increase in output and fall in Price level.





The student gives an answer to the question that states that the proposition is not effective if demand-side policies are being used to control unemployment, but will be effective if supply-side policies are used. This is an evaluation of the two sets of policies.

The proposition that the priority in economic management should be the maintenance of low unemployment is therefore not a good or effective proposition if unemployment is controlled by demand-side policies, as they lead often to high levels of inflation. The proposition should therefore be that an economy should be managed through supply-side policies as they manage to maintain low unemployment in combination with achieving economic growth and low inflation. Supply-side policies do however in essence deal with keeping low levels of unemployment, so the proposition is valid only if it is combined or carried out through supply-side policies.



The student does not finish strongly and makes some unsupported statements.

Keynsians do often argue however that supply-side policies lead to a shifting of the AD curve to the right, resulting actually also in inflation. An effective supply-side policy should therefore also use monetary policy to control the AD curve. This therefore proves that only a combination of both policies will work.



## Examiner report

The student showed clear understanding of the specific demands of the question, and relevant economic theory was clearly explained and developed. Relevant economic terms were defined, diagrams were included and explained, and there was evidence of evaluation in the second last paragraph for example. This just puts the response into level 4 and explains the 13 marks given.

This was a well-structured answer and corresponded nicely to the marking criteria, the ending could have been stronger and there was a lack of examples. Some indication of real unemployment and inflation rates in a country with which the student was familiar would have improved the quality of the response. The answer would have also been enhanced by defining inflation and unemployment and making reference to other macroeconomic objectives in the pursuit of low unemployment.



## 9. International economics

### What you should know

#### Reasons for trade

##### You should be able to:

- define and give examples of factor endowments, specialization, and political factors as reasons for trade
- define, explain, and give examples of absolute and comparative advantage
- show absolute and comparative advantage through both numerical and diagrammatic representations
- explain the importance of the role of opportunity cost in the concept of comparative advantage
- explain the limitations of the theory of comparative advantage.

#### Free trade and protectionism

##### You should be able to:

- define, explain, and give examples of tariffs, quotas, and subsidies as means of protectionism, and show all of the above in diagrams
- define, explain, and give examples of Voluntary Export Restraints (VERs), administrative obstacles, health and safety standards, and environmental standards as means of protectionism
- explain the infant industry argument, the need for diversification, protection of employment, a source of government revenue, strategic arguments, overcoming balance of payments disequilibrium, and anti-dumping as arguments for protectionism
- explain the inefficiency of resource allocation, the costs of long-run protectionism, increased consumer prices, and damage to export competitiveness as arguments against protectionism.